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International Aspects of Corporate-Shareholder Tax Integration

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International Aspects of Corporate-Shareholder Tax Integration

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Mr. Carlson examines the various methods of integration of corporate and shareholder taxes. The article emphasizes the international consequences of integration by comparing the imputation method of shareholder taxation, employed by many counties, with the separate-entity theory which is the basis of the United States tax system. The author notes the concern of the United States in maintaining capital export neutrality, nondiscrimination in taxation, and equitable division of revenue between source and residence jurisdictions. He offers a proposal which suggests that these goals may be accomplished while integrating the United States corporate-shareholder tax system in order to promote capital formation.

I. Introduction

The integration of corporate and shareholder taxes has received considerable attention in recent years. Several major trading partners of the United States, including Canada, France, Germany, Japan, and the United Kingdom, have integrated their tax structures by giving individual shareholders a credit for taxes paid at the corporate level on distributed corporate earnings. In response to a perceived inadequacy of capital formation, integration has also aroused the interest of policy makers in the United States.

The Ford Administration, for example, proposed dividend integration as part of its 1975 tax reform recommendations.[1] In 1976 the Task Force on Capital Formation of the House Committee on Ways and Means examined integration as part of its study of investment needs and incentives.[2] In response to one of President Carter's cam-

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[1] *Tax Reform Proposals: Public Hearings Before the Committee on Ways and Means*, 94th Cong., 1st Sess. 3843 (1976) (statement of William E. Simon, Secretary of the Treasury).

[2] JOINT COMMITTEE ON TAXATION, 95TH CONG., 1ST SESS., TAX POLICY AND CAPITAL FORMATION 9 (Comm. Print 1977).

paign pledges, the Treasury Department looked closely at several methods for integrating corporate and individual income taxes while developing the Administration's 1978 tax reform proposals. Because of the complexity of the issues and the need for an immediate economic stimulus, the Administration ultimately decided not to propose an integration plan.[3] Most recently, Chairman Ullman of the Committee on Ways and Means proposed a partial integration plan as an "important start toward making corporate finance more efficient and more responsive to the country's need for increased capital formation."[4] The Congress, however, in passing the Revenue Act of 1978, opted for lower corporate rates and a more generous investment tax credit as the vehicle for reduced taxation of capital.

While there are a variety of methods available,[5] most of the countries which have integrated their tax systems allow individual shareholders a credit for taxes paid at the corporate level on distributed earnings. In effect, some of the taxes paid by the corporation are "imputed to," or treated as paid by, the shareholder.

This form of integration, coupled with the flow of capital across international borders, gives rise to two important international taxation issues:

(1) Whether nonresident shareholders are entitled to the credit for corporate taxes.
(2) Whether a resident taxpayer is entitled to the credit for foreign corporate taxes paid.

The first issue concerns whether the country adopting the integrated system would extend the credit to nonresident shareholders in domestic corporations. The second issue concerns whether a foreign corporate tax would be creditable against the domestic income tax in the shareholder's country of residence.

This article analyzes these issues with respect to three of the basic principles of United States international tax policy: capital export neutrality, nondiscrimination in the taxation of residents and

[3] See Statement of Donald C. Lubick, Acting Assistant Secretary of the Treasury for Tax Policy, *Integration of the Corporate and Individual Income Tax,* Before the Committee on Ways and Means of the House of Representatives, April 7, 1978, Treasury Department News Release, B-818.

[4] 124 CONG. REC. H640 (daily ed. Feb. 2, 1978).

[5] See Ault, *International Issues in Corporate Tax Integration,* 10 LAW & POL'Y IN INT'L BUS. 461 (1978); J. CHOWN, THE REFORM OF CORPORATION TAX (London: Institute for Fiscal Studies, Publication No. 2, 1971); C. McLure, International Aspects of Integration, ch. VI (unpublished Brookings Institute Manuscript).

nonresidents, and an equitable division of tax revenues between the source and residence jurisdictions. The paper begins with a review of the taxation of corporations and shareholders under separate entity and integrated tax systems.

II. PRESENT LAW

A. *Separate Entity System*

With limited exceptions, the United States has a classical or separate entity system of taxation.[6] A corporation is taxed on its earnings (as a separate entity) and its shareholders are taxed on distributed earnings. Double taxation is reduced at the corporate level by allowing a United States corporation to deduct eighty-five percent or 100 percent, depending on the degree of affiliation, of dividends received from other United States corporations.[7] Generally speaking, individual shareholders are fully taxable on distributed earnings.[8]

The present United States corporate tax rates are seventeen percent on the first $25,000 of taxable income, twenty percent on all income in excess of $25,000 up to $50,000, thirty percent on all income in excess of $50,000 up to $75,000, forty percent on all income in excess of $75,000 up to $100,000 and forty-six percent on all income in excess of $100,000.[9] Resident individuals are subject to tax on dividends at rates ranging from fourteen to seventy percent.[10] Nonresident alien individuals and foreign corporations are subject to a statutory withholding tax of thirty percent on dividend income not effectively connected with a United States trade or business.[11]

The separate entity principle extends to United States shareholders in a foreign corporation. All United States citizens, residents, and corporations are subject to United States taxation on their worldwide

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[6] Subchapter S of the Internal Revenue Code is a notable exception. It permits a corporation with 15 or fewer shareholders to elect not to pay corporate tax on its income and instead have the shareholders pay taxes on the income, whether distributed or not.

[7] I.R.C. § 243.

[8] A shareholder is allowed to exclude $100 of dividends from taxable domestic corporations from his taxable income. I.R.C. § 116. Prior to 1964, the law provided for an exclusion from income of first $50 of dividends received from domestic corporations as well as a four percent credit against tax of dividends in excess of $50.

[9] I.R.C. § 11.

[10] I.R.C. § 1.

[11] I.R.C. §§ 871 and 881. An income tax treaty between the United States and another country usually provides a reduced, to fifteen percent or less, withholding rate on dividends.

income. Generally, however, United States shareholders in a foreign corporation are taxable only on income received as dividends, not on income retained by the foreign corporation. Due to the fact that no United States tax is imposed until the earnings of a foreign corporation are distributed to the United States shareholders, the separate entity system confers a deferral upon the shareholders.

B. *Integration Systems*

There are a variety of methods for integrating corporate and individual income taxes. Under full integration, which no country has adopted, all of a corporation's income, whether distributed or not, would be taxable only to the shareholders. The corporation thus would be taxable as a partnership. To minimize liquidity problems at the shareholder level, the corporate tax would probably be kept as a withholding device to be creditable against the shareholders' individual tax liability.[12]

The countries which have integrated their tax structures have done so only with respect to distributed earnings. This is known as partial integration and can be accomplished by either (1) the split-rate or dividend deduction method or (2) an imputation or shareholder credit system. The former provides relief at the corporate level by taxing dividends at either a reduced or zero rate. Prior to 1976, the German split-rate system provided for a fifty-one percent tax on retained earnings and a fifteen percent tax on distributed earnings.

The imputation or shareholder credit method of integration has been adopted by Canada, France, and the United Kingdom. In contrast to the split-rate system, tax relief is provided at the shareholder level by allowing the shareholder a credit for part (partial imputation) or all (full imputation) of the corporate taxes paid on distributed earnings. Some countries, such as Germany and Japan, have adopted a "hybrid" system with both a split-rate and shareholder credit.[13]

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[12] This was one of the recommendations of the Canadian Royal Commission on Taxation, also known as the Carter Commission. *See* Canada Royal Commission on Taxation, 4 Report of the Commission on Taxation 3 (1966); Bucovetsky and Bird, *Tax Reform in Canada: A Progress Report*, 25 NAT'L TAX J. 15 (1972).

[13] For a detailed description of foreign integration systems see H. AULT & A. RADLER, THE GERMAN CORPORATION TAX REFORM LAW (1976); CHOWN, *supra* note 5; Harry G. Gourevitch, Integration of Corporate and Shareholder Taxes on Income: The European Experience, Congressional Research Service, Library of Congress, May 1977; NTA-TIA Symposium, *The Taxation of Income from Corporate Shareholding*, 28 NAT'L TAX J. 255 (1975); and M. Sato & R. Bird, International Aspects of the

The dividend deduction and imputation systems are illustrated in examples 1 and 2.

Example 1

Dividend Deduction System

Corporation			Individual Shareholder		
				Tax Rate	
Income		$100		20%	60%
Dividend		40	Cash dividend	$40	$40
Dividend deduction (50%)		20	Tax	8	24
Taxable income		$80	After-tax cash flow	32	16
Tax (50%)		40	Total:		
After-tax income		60	Corporate plus shareholder,		
Retained earnings	$20		tax	48	64
Dividend	40				

In example 1, the corporation is allowed to deduct fifty percent of dividends paid. Assuming a tax rate of fifty percent, it has a tax liability of $40 and retained earnings of $20 after paying a dividend of $40. The shareholder's after-tax cash flow is $32 and $16, assuming individual income tax rates of twenty percent and sixty percent, respectively.

Example 2

Shareholder Imputation System

Corporation			Individual Shareholder		
				Tax Rate	
Income		$100		20%	60%
Corporate tax		50	Cash dividend	$30	$30
After-tax income		$50	Gross up (⅓)	10	10
Retained earnings	$20		Gross dividend	$40	$40
Dividend	30		Tax	8	24
			Tax credit	10	10
			After-tax cash flow	32	16
			Total:		
			Corporate plus shareholder tax	48	64

Taxation of Corporations and Shareholders, International Monetary Fund Staff Papers, 389 (May 1974).

This system allows the shareholder a credit, equal to one-third of the dividend, for taxes paid at the corporate level. The shareholder "grosses up" or increases the $30 cash dividend by the $10 in corporate tax claimed as a credit at the shareholder level.[14] The shareholder is taxed on the "grossed up" dividend, but he is entitled to a credit of $10 for part of the corporate taxes paid. The corporation's and the individual shareholder's cash flow are the same as in Example 1.

Thus, while the split-rate system nominally provides relief at the corporate level and the imputation system at the shareholder level, the two can be made equivalent. This requires, however, that the cash dividend be reduced under an imputation system. The lower cash dividend leaves the shareholder in the same after-tax position because he receives a tax credit with the dividend. After-tax corporate profits (dividends plus retained earnings) are higher, however, under the dividend deduction system.

III. PRINCIPLES OF UNITED STATES INTERNATIONAL TAX POLICY

Under either a separate entity or integrated tax system, the movement of capital across national boundaries gives rise to competing tax claims. The two basic jurisdictional standards for asserting tax liability are source and residence.[15] Under the source standard, a country asserts tax jurisdiction over income earned within its geographical area. It makes no difference who receives the income; residents and nonresidents are both taxed on income derived from within the source jurisdiction.[16]

The residence of the taxpayer, rather than the source of income, is the relevant criterion under the residence principle. Residence is usually defined in terms of domicile for individuals and place of incorporation

[14] It may seem odd to require the shareholder to include corporate taxes in his taxable income. This is necessary because the imputation system treats taxes paid at the corporate level as paid by the shareholder, *i.e.*, imputes them to the shareholder. This part of the corporate tax can be thought of as a withholding tax, similar to wage withholding, against the shareholder's individual tax liability. It is included in the shareholder's income, just as is the withholding tax on wages.

[15] The United States also taxes on the basis of citizenship.

[16] Residents and nonresidents are not necessarily taxed the same. Sections 871 and 881 of the Internal Revenue Code, for example, impose a flat-rate tax of thirty percent on United States-source dividends, not effectively connected with a United States trade or business, received by non-resident alien individuals and foreign corporations. Although known as a withholding tax, the thirty percent tax does not represent a prepayment of domestic income tax, but a final tax payment that is a substitute for being taxed at the regular rates applied to resident individuals and corporations.

or management for corporations. Worldwide taxation is closely related to the residence principle since a resident may be subject to taxation on income from all sources, foreign and domestic alike.

Most countries have a combination of source and residence rules. United States citizens and residents are subject to United States taxation on their worldwide income, while nonresident foreign taxpayers are generally subject to United States taxation only on their United States source income.[17] The same income will be taxed twice if it is subject to taxation in both the source and residence jurisdictions. A foreign subsidiary of a United States corporation, for example, normally will be subject to foreign tax on its earnings in the source jurisdiction and the subsidiary's dividends will be subject to United States taxation when received by the parent.

The need to resolve this double international taxation has given rise to the following basic principles of United States international tax policy: capital export neutrality, nondiscrimination between residents and nonresidents, and a reasonable division of revenue between the source and residence countries.

A. *Capital Export Neutrality*

This principle requires that an enterprise pay the same total taxation on its foreign as on its domestic profits. If, for example, a foreign subsidiary of a United States corporation is taxed in the foreign country at forty percent, capital export neutrality would require a current United States tax of six percent on those profits.[18] Capital export neutrality tends to maximize world output or efficiency by permitting investment decisions to be made independent of tax considerations on the basis of the most favorable pre-tax rates of return.[19] Capital is

[17] Nonresident foreign taxpayers are subject to United States taxation at the normal rates on income "effectively connected" with a United States trade or business and to the basic thirty percent withholding tax on United States source investment income, such as dividends, interest, and royalties. The thirty percent rate frequently is reduced by a tax treaty.

[18] This assumes a United States corporate tax rate of forty-six percent. The effective United States rate on domestic profits is, however, less than this because of the investment tax credit and asset depreciation range, which are not available for foreign investment. Equal investment incentives relate, of course, to effective, not nominal, rates.

[19] An alternative criterion is the maximization of national, rather than world, income. This would be accomplished by allowing a deduction, rather than a credit, for foreign taxes. Still another concept is capital import neutrality which is achieved when both foreign and domestic firms pay the same ultimate tax in the country in which

allocated optimally in that it is invested where, adjusted for risk, its return is greatest.

The foreign tax credit is the cornerstone of the United States policy of capital export neutrality.[20] Foreign and domestic profits of a United States corporation tend to be taxed the same because taxes paid to a foreign country can be subtracted from the taxpayer's United States tax liability. The credit is available for income taxes paid on foreign branch earnings, withholding taxes on dividends from a foreign corporation,[21] and the corporate tax on the underlying earnings out of which the dividends are paid, provided the United States taxpayer is a corporation which owns at least ten percent of the foreign corporation.[22]

The credit is limited to the United States tax liability on the taxpayer's foreign source income.[23] A taxpayer therefore pays the higher of the United States or foreign rate. If, for example, the United States rate is forty-eight percent and the foreign rate is forty-four percent, the United States Treasury will collect four percent from the United States taxpayer. If, however, the foreign rate is fifty-two percent, the United States Treasury will neither collect revenue, nor refund the four percent excess to the United States taxpayer.[24] The purpose of the limit is to prevent foreign taxes from reducing United States tax revenue derived from domestic source income.

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they are operating. For a discussion and evaluation of these concepts see G. C. Hufbauer, A. Guide to Law and Policy, U.S. Taxation of American Business Abroad, American Enterprise Institute, Washington, D.C. (1975); PEGGY B. WYSGRAVE, JOINT ECONOMIC COMMITTEE, TAX PREFERENCES TO FOREIGN INVESTMENT, 92nd Cong., 1st Sess. 176 (1972).

[20] The policy is more properly characterized as modified capital export neutrality in that foreign taxes are creditable only up to the United States level, and earnings of a foreign subsidiary are not taxed until repatriated as dividends.

[21] Unlike a withholding tax on the wages of a resident, a dividend withholding tax is levied at a flat rate and is a final, rather than provisional tax payment. Withholding taxes on dividends paid to nonresidents frequently are reduced to ten or fifteen percent by treaty.

[22] I.R.C. § 902.

[23] I.R.C. § 904.

[24] Prior to the Tax Reform Act of 1976, the foreign tax credit limitation could be determined on either a per-country or overall basis. The Act repealed the per-country limitation and requires all taxpayers to use the overall method. This method combines income from various sources, effectively enabling an averaging of high and low foreign tax rates. If a taxpayer has foreign income that has been subject to a relatively low tax, it is possible the entire fifty-two percent foreign tax in the above example would be creditable against the United States tax liability.

B. *Nondiscrimination*

This principle, which requires equal tax treatment for residents and nonresidents, is another tenet of United States international tax policy. In theory, a foreign branch or subsidiary of a United States corporation should not be subject to heavier taxation in the foreign country than a branch or subisidary of a domestic corporation is taxed in that country. United States treaty policy is aimed at assuring that United States investors are not subject to discriminatory tax treatment by a foreign country. United States statutory policy aims at nondiscriminatory United States taxation of foreigners. While it is true that dividends from a foreign subsidiary are usually subject to a withholding tax in the foreign country, this is acknowledged to be an acceptable alternative to the inability of the source country to subject a nonresident's entire income to its individual income tax system. Residents normally are taxed on their global income, while nonresidents are taxed only on a source basis.

C. *Tax Revenue Division*

The United States also is interested in an equitable or reasonable division of tax revenue between the source and residence countries. The foreign tax credit cedes the first slice of tax revenue to the source jurisdiction, leaving the residence jurisdiction with only residual taxing rights. The United States feels this is reasonable in that it is appropriate for the source jurisdiction to receive the major share of the revenue.

IV. ANALYSIS

Most of the countries which have integrated their tax systems have chosen the shareholder imputation, rather than the dividend deduction system. This reflects, at least in part, a desire to explicitly exclude nonresident shareholders from the benefits of integration by not extending the imputation credit to them. These countries are aware that the split-rate or dividend deduction system automatically extends the benefits of integration to nonresident shareholders through the reduced or zero rate applied to all dividend distributions. It would be possible to effectively deny the benefits of integration by levying an increased withholding tax on distributions to nonresidents, but existing treaties with provisions for reciprocal withholding rates generally would prohibit this.

A. *Imputation Credit to Nonresidents: Portfolio Investment*

Largely because of revenue considerations, imputation countries are reluctant to extend the integration tax credit to nonresident shareholders in domestic corporations.[25] Separate entity countries, like the United States, argue that the principle of nondiscrimination demands its extension. Table 1, below, which assumes a separate entity system in the United States and a shareholder imputation or gross up and credit system in the foreign country, provides a basis for evaluating these claims with respect to an individual shareholder's portfolio, or less than ten percent ownership investment.

Table 1

Cash Flow and Tax Liability Consequences for Resident and Nonresident Portfolio Shareholders under Separate Entity and Foreign Imputation Systems[1*]

Shareholder's Income and Tax	Resident Shareholder in United States Corporation (1)	Resident Shareholder in Foreign Corporation (2)	Nonresident Shareholder in Foreign Corporation: No Credit (3)	Nonresident Shareholder in Foreign Corporation: Full Credit Extended (4)
1. Cash Dividend	$100	$100	$100	$100
2. Gross up	—	50	—	50
3. Taxable Income (1 + 2)	100	150	—	150
4. Tentative Tax Liability[2*]	33.33	50	33.33	50
4(a). U.S.[3*]	33.33	—	18.33	27.50
4(b). Foreign[4*]	—	50	15	22.50
5. Shareholder Imputation Credit (2 = 5)	—	50	—	50
6. Net Tax Liability (4-5)	33.33	0	33.33	0
6(a). U.S.	33.33	—	18.33	27.50
6(b). Foreign	—	0	15	(27.50)[5*]
7. After-tax Cash Flow (1-6)	66.67	100	66.67	100

[25] The integration tax credit has been extended by treaty to nonresident

This table was compiled by the Office of the Secretary of the Treasury, Office of Tax Analysis, June 16, 1978.

1* The hypothetical foreign imputation system provides for a gross up and credit equal to one-half the cash dividend. Assuming a corporate tax rate of fifty percent, this would integrate one-half the corporate tax with the individual income tax.

2* This assumes an individual tax rate of one-third in the shareholder's country of residence.

3* This assumes a shareholder receives credit for foreign taxes against United States tax liability.

4* This assumes a nonresident shareholder is subject to withholding tax of fifteen percent on taxable income.

5* Withholding tax of $22.50 less credit of $50, for a refund of $27.50.

Column 1 shows that a resident individual shareholder receiving a $100 dividend from a United States corporation and subject to an individual tax rate of one-third would have an after-tax cash flow of $66.67. A similarly situated resident individual in the imputation country would receive $100 according to column 2. The integration of the corporate and shareholder taxes in the foreign country accounts for the difference.

Column 3 shows that a nonresident shareholder who does *not* receive the imputation credit also would receive an after-tax payment of $66.67. This would appear to fulfill the goal of capital export neutrality. In addition, the revenue split (roughly $18 United States and $15 foreign) would seem to be reasonable. Nonetheless, denying the credit to a nonresident shareholder violates the principle of nondiscrimination. The nonresident shareholder is subject to heavier taxation in the foreign country than is the resident shareholder because he receives a net dividend of only $85 ($100 cash less $15 withholding tax), whereas the resident shareholder receives a net dividend of $100. An important practical consequence is that the switch from a classical to an integrated system will probably mean a reduced after-tax cash flow for the foreign investor. Most corporations would probably reduce their cash dividends in response to the imputation system. Resident

shareholders. Under the January 1, 1970 protocol to the United States-France income tax treaty, France extends the same shareholder credit to United States individuals and corporate portfolio investors in a French corporation that it provides for French investors. A United States corporation which owns ten percent or more of the shares of a French corporation, and is thus a direct, rather than portfolio, investor, is excluded from the scope of the protocol. *See* 1 TAX TREATIES (CCH) ¶ 2813.

shareholders would still be likely to have an increased after-tax cash flow because of their entitlement to a tax credit. The nonresident shareholders, however, will be left with only the smaller cash dividend.

Extending the credit to the nonresident shareholder, as shown in column 4, eliminates this discrimination. Both residents and nonresidents are taxable on a cash dividend of $100 plus a $50 shareholder credit.[26] This may, however, be inconsistent with capital export neutrality since the nonresident shareholder in a foreign corporation now receives an after-tax payment of $100 while the resident shareholder in a United States corporation receives only $66.67. One might contend that foreign and domestic profits bear the same total individual tax rate (one-third), but the total foreign dividend (cash plus tax credit) is larger because of the reduction in corporate tax inherent in the imputation system. Still, for a given cash dividend ($100), the investor in the foreign corporation receives a larger after-tax cash flow than the investor in a United States corporation.

The revenue division is altered greatly if the source country extends the imputation credit to nonresidents since it will be giving up all of the integrated portion of its corporate income tax with respect to dividends paid to nonresidents. It is left with only the revenue from the unintegrated portion of its corporate income tax. A country, such as Germany, which has integrated its entire corporate tax on distributed earnings (full imputation, but not full integration) would, except for a withholding tax, collect no tax on dividends paid to nonresidents. This result might be reasonable if one views the German system, which gives a resident shareholder full credit against his individual tax liability for corporate taxes paid on dividend income, as totally eliminating the corporate tax on distributed earnings.

B. *Imputation Credit to Nonresidents: Direct Investment*

The imputation countries are even more reluctant to extend the shareholder credit to nonresident direct investors.[27] In addition to the

[26] It is true that the nonresident shareholder is taxed at only a fifteen percent withholding rate on a grossed-up dividend of $150 while the resident shareholder is taxed at an individual tax rate of thirty-three and a third percent. A withholding tax on nonresidents, however, is the internationally-accepted alternative to the taxation of resident individuals at the regular rates. It is not intended as a full or final tax since only the country of residence can determine the appropriate tax burden by giving consideration to the taxpayer's total income, deductions, and exemptions. The withholding tax concept is *not* considered a departure from the non-discrimination principle.

[27] The United States-United Kingdom Income Tax Treaty, recently ratified by the

obvious revenue considerations, they point out that the theory of an imputation system is to provide relief for corporate taxes with respect to distributions taxed at the individual level. Since a direct investor with at least ten percent ownership normally will be a corporation, they feel there is little reason for providing corporate tax relief for distributions still in corporate solution. Moreover, because of the operation of the indirect or deemed paid foreign tax credit,[28] the benefits of extending the credit to direct investors frequently will go to the treasury of the residence country rather than to the shareholder.

From the viewpoint of separate entity countries, such as the United States, it is discriminatory to deny the credit to nonresidents. The argument put forth is that the imputation country has decided to reduce its level of corporate taxation on distributed earnings. Whether this is done through an imputation credit or a reduced rate on distributed earnings is immaterial; to tax residents and nonresidents differently violates the principle of nondiscrimination. Suppose, to illustrate the point, that a corporation wholly owned by residents paid no corporate tax, but a corporation wholly owned by nonresidents paid a fifty percent corporate tax. The separate entity countries argue that this clearly would be discriminatory and that denying the imputation credit to nonresidents is similarly discriminatory.

Table 2 below provides a basis for evaluating these views. It is assumed that the United States has a separate entity system of taxation and that the foreign country has partially integrated its taxes via the imputation method.

Column 1 shows that a United States resident individual receiving a $100 dividend from a United States corporation and subject to an individual tax rate of one-third would have an after-tax cash flow of $66.67. The United States, of course, would collect the entire $133.33 in tax on the $200 in income earned at the corporate level. According to column 2, a foreign resident individual investing in a foreign corporation would receive after-tax income of $80. Although the corporate tax rate is assumed to be higher in the foreign country, the individual shareholder receives a higher after-tax payment because of integration.

Senate, but with a reservation on another issue, is a notable exception. That treaty would extend one-half of the United Kingdom imputation credit to United States direct investors in United Kingdom corporations. See 2 TAX TREATIES (CCH) ¶ 8107-5—8107-27(d).

[28] This is the credit for foreign taxes paid on the corporate earnings out of which the distributions are paid. *See* I.R.C. § 902.

Table 2[1*]

Cash Flow and Tax Liability Consequences for Resident and Nonresident Direct Investors under United States Separate Entity and Foreign Imputation Systems[2*]

	United States Corporation (1)	Foreign Corporation (2)	Foreign Corporation (3)	Foreign Corporation (4)	Foreign Corporation (5)
1. Corporate Level Income					
2. Taxable Income	$200	$200	$200	$200	$200
3. Corporate Tax[3*]	100	120	120	120	120
4. Net Income (2-3)	100	80	80	80	80
5. Cash Dividend	100	80	80	80	80
6. Dividend Received by:	Resident	Resident	Nonresident No credit	Nonresident 50% credit	Nonresident 60% credit
7. United States Corporation					
8. Cash Dividend			$ 80	$ 80	$ 80
9. Shareholder Imputation Credit[4*]			—	20	24
10. Gross up[5*]			120	100	96
11. Taxable Income (8 + 9 + 10)			200	200	200
12. Tentative Tax Liability[3*]			100	100	100
13. Foreign Tax Credit[6*]			100	100	96
14. Net U.S. Tax (12-13)			0	0	4
15. Cash Dividend to Individual Shareholder (8 + 9-14)			80	100	100

16. Individual Shareholder					
17. Cash Dividend	$100	$ 80	$ 80	$100	$100
18. Gross up	—	40	—	—	—
19. Taxable Income (17 + 18)	100	120	80	100	100
20. Tentative Tax Liability[7*]	33.33	40	26.67	33.33	33.33
21. Shareholder Imputation Credit (21 = 18)	—	40	—	—	—
22. Net Tax Liability (20-21)	33.33	0	26.67	33.33	33.33
23. After-tax Cash Flow (17-22)	66.67	80	53.33	66.67	66.67
24. Total Tax Liability	$133.33	$120	$146.67	$133.33	$133.33
24(a). United States	133 (3 + 22)	0	26.67 (22)	33.33 (22)	37.33 (14 + 22)
24(b). Foreign	0	120 (3 + 22)	120 (3)	100 (3-9)	96 (3-9)

1* This table is from materials of the Office of the Secretary of the Treasury, Office of Tax Analysis, June 16, 1978.

2* The hypothetical foreign imputation system provides resident shareholders with a gross up and credit equal to one-half the cash dividend. Assuming a corporate tax rate of sixty percent, this would integrate one-third of the corporate tax with the individual income tax.

3* This assumes a corporate tax rate of fifty percent in the United States, sixty percent in the foreign country.

4* In the two cases where the credit is extended, it is equal to fifty percent and sixty percent, respectively, of the credit available to resident shareholders.

5* For purposes of claiming the foreign tax credit under the United States Internal Revenue Code, dividends from a foreign corporation are increased or "grossed up" by the amount of foreign taxes deemed paid with respect to the dividends received. The allowable foreign tax credit is then based on the foreign taxes paid on these grossed up earnings, including the amount paid as foreign taxes, and not merely the portion paid as a dividend.

6* This is limited to the lesser of United States or foreign taxes.

7* This assumes an individual tax rate of one-third in the shareholder's country of residence.

Columns 3 through 5 illustrate the position of a nonresident shareholder in a foreign corporation under differing treatment of the imputation credit. Since the foreign direct investor is assumed to be a corporation, a United States corporation is interposed between the foreign corporation and the United States resident individual shareholder.

If the imputation country does not extend the credit, the United States corporate shareholder receives a dividend of $80. Since the corporation's United States tax liability is offset by its foreign tax credit,[29] the individual shareholder receives a dividend of $80 on which he pays a tax of $26.67, leaving an after-tax income of $53.33. This may appear inconsistent with capital export neutrality since the United States resident individual investing in a United States corporation receives $66.67. The $13.34 difference, however, is attributable to the fact that the foreign corporate taxes in excess of the United States corporate tax rate are not creditable for United States tax purposes. Nevertheless, if the credit were extended to nonresidents, this would facilitate capital export neutrality by effectively lowering the foreign corporate tax rate.

Although the resident and nonresident individuals receive the same cash dividend, $80, the $53.33 received by the nonresident individual appears to be discriminary. The difference is that one country has integrated its tax system and the other country has not. Those arguing discriminatory tax treatment contend that this misses the point. The resident shareholder, they say, receives an imputation credit of $40 in

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[29] The United States tax liability is more than offset. The indirect or deemed paid foreign tax credit is equal to:

$$\frac{\text{dividend received}}{\text{net earnings}} \quad \text{x} \quad \text{foreign tax paid or}$$

$$\frac{80}{80} \quad \text{x} \quad 120 \quad = \quad 120$$

Assuming a United States corporate tax rate of fifty percent, the tentative United States tax liability on the $200 in grossed-up foreign earnings is $100. The foreign tax credit is limited, however, to:

$$\frac{\text{foreign taxable income}}{\text{worldwide taxable income}} \quad \text{x} \quad \begin{array}{c}\text{tentative United States}\\ \text{tax on worldwide income or}\end{array}$$

$$\frac{200}{200} \quad \text{x} \quad 100 \quad = \quad \$100.$$

The purpose of this limit is to prevent foreign taxes from reducing the United States tax otherwise due on domestic source income. The $20 excess credit is available, however, to offset United States taxes on foreign income that has been subject to relatively low taxation in a foreign country.

addition to an $80 cash dividend, while the nonresident receives only an $80 cash dividend. A direct investor, because of its substantial ownership interest, is assumed to be able to control the dividend-paying corporation. The nonresident direct investor could therefore increase its after-tax income by increasing the level of cash dividends paid by the foreign corporation. Still, for a given level of corporate earnings, a corporation controlled by nonresidents will pay higher taxes than a corporation owned by residents.

Finally, there is the issue of revenue division. Through the foreign tax credit, the United States cedes the first slice of tax revenue to the source jurisdiction. This slice becomes the entire pie when foreign rates equal or exceed United States rates. The United States is left with only its tax collected from individual shareholders. Denying the credit to nonresidents preserves this arrangement, but it does so arguably by taxing nonresidents more heavily than residents. In effect, nonresidents are asked to finance part of the revenue cost of integration by bearing a heavier corporate tax in the imputation country.

Columns 4 and 5 illustrate cases where the imputation country extends fifty percent and sixty percent, respectively, of the credit to nonresident direct investors. A rationale for this limited extension, in addition to source country revenue considerations, might be that roughly one-half of corporate earnings are distributed to individual shareholders. Since the theory of integration is to provide relief for only those earnings that pass out of corporate solution, one can argue it is appropriate to extend about one-half the credit to nonresident direct investors.

If one-half the credit is extended, the United States corporation receives an $80 cash dividend from the foreign corporation and a $20 imputation credit from the foreign treasury. The credit is equivalent to a reduction in foreign corporate tax. Accordingly, the United States corporation's tentative United States tax liability of $100 is exactly offset by the foreign tax credit, and it distributes $100 to its individual shareholders. A shareholder taxed at an individual rate of one-third would have $66.67 in after-tax income.

Capital export neutrality is achieved because all foreign taxes are now creditable. There is still room for debate as to whether the nonresident shareholder is taxed more heavily than the resident shareholder in the imputation country. The arguments are the same as recited above and need not be reiterated except to note that since the position of the shareholder has improved, any discrimination has been reduced. Because of the effective reduction in foreign taxes, the revenue division is slightly more favorable to the United States. Still, the United States collects no corporate tax on foreign earnings.

The case in which the nonresident's share of the credit is increased to sixty percent of the resident credit deserves special mention. The effective foreign corporate rate, allowing for the imputation credit, now falls below the United States corporate rate. The dividend to the individual shareholder, however, cannot be more than $100 because the United States will always collect the residual corporate tax.[30] The imputation countries tend to focus on this point. They note that the combined impact in the residence country of residual corporate taxation and no relief at the shareholder level means that a nonresident can never be made "whole" with a resident.

Separate entity countries respond that how they tax their residents is not the proper concern of the source country. Nondiscrimination means equal tax treatment of residents and nonresidents in the source country. Accordingly, nonresidents should receive the same imputation credit as residents. The fact that it may end up in the coffers of the other country's treasury, rather than in the shareholder's pocket, is a choice more properly left to the residence country.

The sixty percent credit also allows all foreign taxes to be credited and thus comports with capital export neutrality. The full benefit of the larger credit, however, goes to the United States Treasury. The shareholder receives the same after-tax income. Under these conditions, it is understandable why imputation countries are reluctant to extend the credit to nonresidents. While a capital-importing country may be willing to extend the credit to nonresidents in anticipation of attracting more investment, that anticipation will be frustrated if the benefits of extending the credit go to the foreign treasury, rather than the foreign shareholder.

C. *Integration of Foreign Corporate and Domestic Individual Taxes*

In addition to deciding whether nonresidents will receive the shareholder credit, imputation countries must decide whether foreign corporate taxes will be integrated with the domestic individual income tax in the shareholder's country of residence. Will a resident portfolio shareholder in a foreign corporation, for example, be entitled to a credit for foreign corporate taxes in the same way as the individual investing in a domestic corporation receives a credit for domestic cor-

[30] This is the difference, if any, between the United States and foreign rates.

porate taxes? Or, will an individual receive a credit for domestic taxes not paid by a domestic corporation because of the foreign tax credit? Largely because of revenue considerations, the imputation countries have tended to respond negatively to these questions. Taxes not paid at the corporate level, either because of an exemption for foreign income or because of a foreign tax credit, have not been creditable at the shareholder level.

The following example illustrates the problem with respect to a corporation earning $200 of foreign source income that is not taxed in the residence country because of a foreign tax credit.[31] Individual shareholders receive a gross up and credit equal to one-half the cash dividend.

Example 3

Corporation			Individual Shareholder	
Income (foreign source)		$200	Cash dividend	$100.00
Tentative domestic tax	$100		Gross up	50.00
Foreign tax credit	100		Taxable income	150.00
Net domestic tax		0	Individual tax	
After-tax income		100	(25% rate)	37.50
Cash dividend		100	Tax credit	50.00
			Tax refund	(12.50)
			Total cash	
			($100 + 12.50) =	$112.50

Due to the foreign tax credit, the residence country collects no tax at the corporate level. If the shareholder credit does *not* depend on which jurisdiction has collected the corporate taxes, the residence country refunds foreign taxes, which it has not collected, to its resident shareholders. Integrating a foreign corporate tax with the domestic individual tax therefore can have drastic revenue consequences for the residence country.

Most imputation countries[32] avoid these consequences by levying a "pick-up" or compensatory tax on distributions of foreign earnings. The function of France's *precompte*, the United Kingdom's ACT, or Germany's increased corporate tax is the same: to assure that taxes

[31] This is not a crucial assumption. The same problem arises in an imputation country that exempts foreign source income.

[32] Canada is a notable exception. The shareholder credit is available for corporate taxes paid to either the Canadian or foreign treasuries. Unlike the French, German, and United Kingdom systems, however, the Canadian credit is not refundable.

creditable at the shareholder level have been collected at the corporate level. The compensatory tax is typically levied at a rate equal to the shareholder credit. If the above example followed this approach, it would be designed to collect $50.00 in tax revenue.

Critics of the pick-up tax mechanism argue that it violates capital export neutrality by taxing foreign investment more heavily than domestic investment. France, Germany, and the United Kingdom have dealt with this by developing favorable dividend ordering or "stacking" rules. In each country, distributions are deemed to be made first from fully-taxed earnings. Thus, a corporation with sufficient domestic income to finance its desired level of distributions will be able to escape the compensatory tax.

D. *"Clearing House" Mechanism between Imputation Countries*

An imputation country may be reluctant to follow the principles of capital export neutrality and nondiscrimination because of adverse revenue consequences. For example, a country which integrates the full corporate tax on distributed earnings, by extending the shareholder credit to nonresidents and passing foreign corporate taxes through to its resident individual shareholders would collect zero or negative[33] tax revenue on the distributed earnings from foreign investment. One answer to this dilemma is a "clearing house" mechanism as suggested by the European Economic Community (EEC) Directive on integration.[34]

The basic principles of the EEC Directive for the distribution of earnings from a subsidiary incorporated in one country to a parent organized in another are as follows:

(1) Dividends from the subsidiary to the parent carry no imputation credit to the parent.

(2) Distributions of foreign earnings from the parent to its individual shareholders carry a credit equal to the imputation credit in the source (subsidiary's) country.

(3) The parent's country levies a compensatory tax if its shareholder credit exceeds that of the subsidiary's country.

(4) The source country bears the cost of its credit.

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[33] This would be negative revenue in that the government would be obligated to make refunds to shareholders of tax which it had not collected at the corporate level.

[34] Commission of the European Communities, Proposal for a Directive of the Council Concerning the Harmonization of Systems of Company Taxation and of Withholding Taxes on Dividends, (July 1975) (unpublished paper, copy on file with *Case W. Res. J. Int'l L.*).

Table 3 below illustrates the operation of a "clearing house" mechanism. The subsidiary operates in a country which has a sixty percent corporate tax rate and an imputation credit equal to forty percent of the cash dividend. The subsidiary earns $200 and distributes $80 to its parent, which pays no corporate tax because of a foreign tax credit.

Table 3[1*]

Cash Flow and Tax Revenue Effects of Clearing House Payment between Two Countries with Shareholder Imputation Systems[2*]

1.	Subsidiary Corporation (Source Country)	
2.	Taxable Income	$200.00
3.	Corporate Tax[3*]	120.00
4.	Net Income (2-3)	80.00
5.	Cash Dividend	80.00
6.	Dividend Received by	
7.	Parent Corporation (Residence Country)	
8.	Cash Dividend	$ 80.00
9.	Gross up[4*]	120.00
10.	Taxable Income (8 + 9)	200.00
11.	Tentative Tax Liability[3*]	100.00
12.	Foreign Tax Credit[5*]	100.00
13.	Net Corporate Tax (11-12)	0
14.	Tentative Dividend (14 = 8)	80.00
15.	Basis for Compensatory Tax[6*]	112.00
16.	Tentative Compensatory Tax[7*]	37.33
17.	Offsetting Imputation Credit	32.00
18.	Net Compensatory Tax (16-17)	5.33
19.	Actual Dividend (8-18)	74.67
20.	Individual Shareholder	
21.	Cash Dividend	$ 74.67
22.	Gross up[2*]	37.33
23.	Taxable Income (21 + 22)	112.00
24.	Tentative Tax Liability[8*]	37.33
25.	Shareholder Imputation Credit (25 = 22)	37.33
26.	Net Tax Liability (24-25)	0
27.	After-Tax Cash Flow (21-26)	74.67
28.	"Clearing House Payment"[9*]	32.00
29.	Total Tax Revenue	125.33
29(a).	United States (18 + 28)	37.33
29(b).	Foreign (3-28)	88.00

1* This table is from materials of the Office of the Secretary of the Treasury, Office of Tax Analysis, June 7, 1978.

2* The imputation system in the subsidiary's country provides a gross up and credit equal to forty percent of the cash dividend and in the parent's country a gross up and credit equal to fifty percent of the cash dividend.

3* This assumes a corporate tax rate of sixty percent in the subsidiary's country and fifty percent in the parent's country.

4* For purposes of claiming the foreign tax credit, dividends from a foreign corporation are increased or "grossed up" by the amount of foreign taxes deemed paid with respect to the dividends received.

5* This is limited to the lesser of the source or residence country rate.

6* The $80 which the parent corporation has available to distribute is accompanied by a forty percent or $32 credit from the subsidiary's country. The sum of these amounts, $112, is the basis of the compensatory tax.

7* Since the gross up and credit in the parent's country is fifty percent of the cash dividend, the maximum compensatory tax would be one-third of the basis or $37.33.

8* This assumes an individual tax rate of one-third in the shareholder's country of residence.

9* Under "clearing house" agreement, country of subsidiary corporation bears cost of its own imputation credit.

The parent is unable to distribute the full $80 to its individual shareholders because its country provides a larger shareholder credit (fifty percent of the dividend) than the subsidiary's country. The parent pays a compensatory tax on the difference and distributes $74.67 in cash plus a credit of fifty percent or $37.33 to its shareholders. A shareholder in the one-third tax bracket would pay no additional tax and would have an after-tax cash flow equal to the dividend, $74.67. Under the "clearing house" arrangement, the source country would pay the cost of its credit, $32.00, directly to the treasury of the parent's country.

Although the EEC Directive on integration has no been adopted by any of the EEC member countries, it is an attractive arrangement for a number of reasons. The imputation credit is available only on earnings distributed to individual shareholders. This is consistent with the theory of integration and responsive to a major concern of the imputation countries. Apart from the limit on the foreign tax credit at the corporate level,[35] the system satisfies capital export neutrality since foreign and domestic earnings are taxed alike. Nondiscrimination is also respected since both residents and nonresidents are taxed alike in the source country and both groups receive the credit.

As regards the division of tax revenues, the source country surrenders the integrated portion of its corporate tax. Since the residence country is assured of the revenue on the integrated portion of its corporate tax, it will not be in the position of crediting (or refunding) tax it has not collected. If the source and residence countries have corporate tax rates of about one-half and integrate about one-half of that tax, as suggested by the EEC Directive, they would divide the revenue on distributed earnings almost equally. This would be a sharp departure from many of the present systems which cede the first and largest slice of tax revenue to the source country.

V. Conclusion

United States international tax policy is based on the principles of capital export neutrality, nondiscriminatory taxation of residents and nonresidents, and a reasonable division of revenue between the source and residence countries. Pursuit of these principles in the face of the trend toward integration has required the United States to ask the imputation countries to extend the shareholder credit to United States investors. Presumably, the United States would be prepared to make the same concession if it decides to follow the trend and integrate its tax system. The United States may be tempted, however, to follow the example of most imputation countries and not integrate foreign corporate taxes with its individual income tax. If so, the principle of capital export neutrality would be sacrificed for tax revenue. The answer to this dilemma may be a "clearing-house" mechanism along the lines of the EEC directive. This would integrate foreign corporate and domestic individual taxes, thus preserving capital export neutrality, while dividing the revenue from distributed corporate earnings about equally between the source and residence countries.

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[35] This shortcoming exists even under the present credit arrangement in classical tax countries such as the United States. It is *not* unique to an integrated system.